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UNCLAS SECTION 01 OF 02 SAO PAULO 000624

SENSITIVE
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TAGS: ECON EFIN EINV ETRD PGOV PREL BR
SUBJECT: BRAZIL: NEW TAX UNLIKELY TO CURB REAL APPRECIATION

REF: BRASILIA 128; BRASILIA 1099

¶1. (SBU) SUMMARY: The Brazilian government's (GoB) October 20 decision to re-impose a two percent tax on financial transactions (IOF) in order to curb appreciation of the local currency is unlikely to have a significant impact controlling the Real's rise or on foreign direct investment. The IOF applies to capital inflows by foreigners for portfolio investment, including for first time equity investments, where it could reduce some short-term inflows. While the decision created some immediate downward pressure on the Real, in the longer term the move is unlikely to deter foreign portfolio inflows as Brazil remains an attractive market with high interest rates. The administration's move was not carefully coordinated with the Central Bank or Trade Ministry prior to announcement. The action represents a political response by the Finance Minister to export sector complaints, but one which is unlikely to have long-term effects on exchange rates or export competitiveness. END SUMMARY

NEW "OLD" TAX MEASURE

¶2. (U) Following a 36 percent rise of the Real against the U.S. dollar this year, and amidst strong complaints from Brazil's exporters, the GOB announced October 20 the re-imposition of a two percent per transaction tax on portfolio investment inflows. The measure, previously limited to fixed income investment and set at 1.5 percent, was suspended in late 2008 when financial flows reversed during the onset of the global financial crisis. With the rapid recuperation of the Brazilian economy in 2009, inflows have returned strongly, particularly in the equity market that now represents about 65 percent of capital inflows. The GoB decided to expand the tax to equity investments as well as bank lending, insurance transactions, and fixed income investment. The IOF does not apply to direct investment inflows, including earning retentions by foreign multinationals in Brazil.

UNLIKELY TO CONTROL REAL, BUT COULD HURT LIQUIDITY

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¶3. (SBU) Most of our contacts agree that this measure is unlikely to curb the currency's appreciation, which is mainly driven by macroeconomic fundamentals. International Finance Corporation Country Director Andrew Gunther and Federation of the Industries of Sao Paulo (FIESP) International Relations Director Mario Marconini told Econoffs separately October 21 the IOF will have only minimal effects, such as short-term market volatility, which is likely to stabilize in the long-run. Brazil's stock exchange, Bovespa, and the Real experienced some very minor volatility as a result of the implementation of the IOF, declining by 2.2 and 1.3 percent respectively the day after the IOF was implemented, only to make-up all of their losses the following day. Both experts agreed that tightening fiscal policy would do more to restrain the Real than the re-implementation of the IOF. Contacts at Brazilian banks Bradesco and Itau-Unibanco also suggested that the IOF, while only 1.9 percent of federal revenues, could actually serve as an excuse for the GOB to further delay necessary fiscal reform.

¶4. (SBU) Consulate contacts such as Bovespa Chairman Arminio Fraga and Chief Executive Officer Edemir Pinto warn that Bovespa, which has received USD 23 billion in foreign inflows since January 1, will be the biggest victim of the IOF. They expressed concern that

the IOF will effectively export Brazil's equity business to New York and drain liquidity from Brazil, thereby increasing price volatility and country risk. Nevertheless, most public criticism has focused on skepticism the IOF will halt the Real's appreciation rather than negative implications for investment.

¶5. (SBU) Central Bank contacts note that Governor Meirelles was only informed of the measure two hours before it was announced. The Central Bank does not support the measure as an effective tool, noting that historically, even with taxes as high as nine percent, investors both build these taxes into their costs of doing business and find ways to circumvent the taxes. Trade Minister Miguel Jorge stated publically that Finance Minister Mantega's suggestion that the tax would help the export sector was incorrect, as exports are more dependent on global economic growth than on exchange rates. Jorge said the tax might help the government with revenue collection, but would not help the export sector's competitiveness. Receita Federal (IRS-equivalent) believes the tax could yield an additional 2 billion reais/year in tax revenues, but Mantega publicly denied this was the reason for imposing the IOF.

MORE MEASURES TO COME?

¶6. (SBU) Given skepticism about the effectiveness of the IOF, speculation has already begun that the Finance Ministry will pursue additional measures to restrain the Real. While President Lula has not ruled out taking additional steps, Finance Minster Mantega has so far downplayed likelihood of imposing additional measures such capital controls on outflows-another area the Central Bank opposes. Capital controls would be very unpopular with Brazilian industry and banks, as well as significantly more complicated to enforce.

COMMENT

¶7. (SBU) Experts' skepticism about the IOF's effectiveness, the potential harm for equity investments, and indications of weak

interagency coordination within the GOB, suggest the decision to re-impose the IOF was a political maneuver by the Finance Ministry rather than a well-coordinated attempt to affect either exchange rates or Brazil's export position. The lack of consultation with the private sector or within the GOB suggests that, despite existence of mechanisms to ensure interagency review and coordination for trade and investment policy, decisions based on political factors can still be made quickly, without full consideration of economic impact. The precipitous (and rescinded) import licenses decision last year (Ref A) and the proposed oil/gas exploration legislation (Ref B) could be considered examples. As Brazil nears the 2010 national elections, the risk of other politically motivated "band-aid" measures grows. However, it should be noted that, under Brazilian law, no new measures affecting the budget (including program funding, minimum wage increases, pension increases, etc) may be implemented within six months of the October 2010 elections.

¶8. (U) This message was coordinated/cleared with Embassy Brasilia.

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